

# SWEDISH SECURITIES DEALERS ASSOCIATION

August 2019

## SSDA response to CPMI-IOSCO Discussion Paper on Central Counterparty Default Management Auctions

The Swedish Securities Dealers' Association (SSDA) welcomes the discussion paper and appreciates the opportunity to provide comments on the CPMI-IOSCO discussion paper on central counterparty default management auctions. As a general note, the SSDA encourages further discussions and knowledge sharing to shed light on auction participant bidding behavior in fire-drills and during live auctions.

### Roles and responsibilities (Chapter 3)

**1. What are the considerations for a CCP's board when determining whether and how to assign tasks related to the planning and conduct of default management auctions within the CCP's risk management framework? How does the CCP's board identify potential limits to the assigned responsibilities?**

CCPs should have in place governance arrangements for confidential information that needs to be shared with a limited group of market participants, i.e. when requesting quotes for hedges. These arrangements should include principles of transparency for selection criteria when certain stakeholders are invited to participate in transactions or are given information and others are not. The arrangements could also help prevent information leakage and give stakeholders the right to challenge those selection criteria.

**2. What different considerations may apply when a CCP's board establishes procedures for consulting external experts, such as independent consultants or clearing members, when designing or conducting a default management auction? How does a CCP's board address such concerns?**

The same considerations as provided under Q1.

## Considerations for a successful auction (Chapter 4)

**3 Do you agree with the description of a successful auction in the discussion paper? Do you agree with the scenarios identified that would constitute an unsuccessful auction, and are there additional such scenarios?**

We agree with the description in the discussion paper of a successful auction but are of the opinion that further criteria should be added:

- “Broad” participation in the auction should be added as a criterion for a successful auction.
- The ultimate goal of the auction is to preserve the integrity of the CCP by minimizing member losses; an auction leading to material member losses should therefore be considered unsuccessful.
- A stricter definition of the success criteria/principles for a successful auction would prove valuable, particularly where two CCPs are simultaneously executing an auction process.
  - Market stability action taken by the CCP to mitigate the risk of the defaulting members' portfolio should itself not destabilise the markets.
  - Minimizing losses for both the CCP and the clearing members.

**4. What are the primary challenges in achieving a successful default auction? In addition to those included in the discussion paper, are there other elements in the design of an auction that a CCP could consider in order to increase the likelihood of a successful auction?**

- Extend fire drills to always include all types of trades that are eligible for clearing within the specific asset class/currency splits set by the CCP, to ensure members can import trades correctly in a default event. Furthermore, impose trade-by-trade tolerances in the valuation part of fire drills to ensure members import all types of trades accurately.
- To promote competitive bidding, CCPs should ex ante increase the transparency for members of the consequences of different outcomes in the auction phase, e.g. the consequence for the individual members if the auction is cancelled, consequence of not participating in the auction, consequence of very conservative bidding in the auction, etc.
- Generally, members which are key players in a market should be identified ex ante and behavior as well as bidding capability should be assessed on an ongoing basis, i.e. in connection with fire-drills.
- If the CCP imposes further discretionary criteria when selecting the winning bid, i.e. the bidder's financial capacity to take/bear the risks of the portfolio or the bidder's market presence, then the CCP should in general disclose those criteria.

**5. What process/set of factors, including applicable governance, is used/considered to determine whether an auction is successful or unsuccessful? What governance would apply to this determination, including the decision whether to run an additional auction (as opposed to using other tools) and why?**

- CCPs should ensure that the DMG's interests are fully aligned to that of the default fund to mitigate instances where the CCP's interest is not fully aligned to the interest of the members.
- Regulators should, giving due consideration to market stability, provide an assessment of the default management process of a CCP shortly after the default.
  - Shortcomings in the default management, i.e. an unsuccessful auction, should give rise to the CCP contributing more into the default fund to help preserve the integrity around the CCP.
- Loss mutualisation through the default fund should be considered a criterion when determining if the auction was successful.

- When determining whether to run an additional auction, the CCP should evaluate if it is likely that members will improve their bidding. This could for example be based on an evaluation of members losses' in the first auction compared to members bidding. If the CCP believes improved bids can be obtained by informing the individual members of the impact of unchanged bids, then a second auction could be held.

**6. What are the considerations for CCPs in choosing to utilise auctions as a default management tool? What product categories are most suitable for auctions and what product categories are least suitable for auctions? How do you assess suitability?**

- It is important to ensure that auction participants can import trades correctly (meaning the correct valuation, etc.) – if this is not possible the auction format is less feasible.
- Provided the CCP can close out the defaulted portfolio via the order book (i.e. the portfolio is sufficiently liquid) without a significant loss, an auction might not be appropriate or necessary as it takes more time and involve risks to run the auction.
  - Without a significant loss means losses so small that mutualized losses to members of the default fund would not take place.

**7. In addition to those outlined in the discussion paper, are there other considerations that may be useful for a CCP to take into account when designing its hedging strategy, including circumstances where a CCP may wish to delay hedging?**

- Governance and transparency around the choices of hedging participants is key, since a large portion of the losses relating to the defaulter's portfolio is determined when the CCP is executing the hedge.
- Members should, as a minimum, simultaneously be informed that a default has occurred and that the hedging phase is imminent. This will at least ensure that all members know that the market will move, but not give away the direction. This would help limit the fallout of any potential frontrunning from members executing trades during the hedging phase.
- Managing information leakage is also key at the hedging stage and the CCP should have sound procedures in place for managing those risks.
- Liquidity and hedging activity should not be of such magnitude that it drives market liquidity issues and impact broad risk management activity.

**8. How do you incorporate cross-margining arrangement considerations in the hedging strategy and in the broader auction design process?**

- Allowing more flexibility in the hedging process by executing hedging across asset classes, may imply that execution is done more efficiently in terms of costs and liquidity. This will, however, complicate the auction, as members would either be required to be members across margin pools or several auctions across margin pools will need to be held with higher market risk.
- The netting benefit from common margin pools for clearing members might evaporate during the default of a clearing member. Therefore, to ensure limited contagious effects, hedging should be conducted within the same margin pools. Otherwise large margin calls across margin pools could trigger another default.

**9. The discussion paper notes that, with respect to hedging, execution methods vary and depend on a CCP's choice of hedging instruments. What methods are used for hedging, and what is the rationale for implementing (or not implementing) a particular method?**

**10. What factors, other than those identified in the discussion paper, do you see as relevant when determining how to split a portfolio? Are there situations where certain factors would be more important than others? Please provide examples.**

**11. The discussion paper describes two common auction formats. Are there other auction formats not included that could be beneficial for a CCP to consider employing? What factors influence the decision to implement (or not implement) a particular auction format?**

**a. Besides promoting competitive bidding, are there other considerations for choosing two-way pricing? Are there circumstances where it would be beneficial or circumstances where it might not be appropriate? If so, please describe.**

Less complexity in the format would encourage bidding from less sophisticated members, which would be particularly useful in a stressful (default) situation.

**b. What are the considerations for choosing to use a reserve price in an auction? Are there circumstances where it would be beneficial or circumstances where it might not be appropriate? If so, please describe.**

**12. The discussion paper highlights two factors that affect the amount of time auction participants may need to evaluate a portfolio and submit bids. Are there other factors that are important to consider? Is there a minimum time period that a CCP should consider providing to auction participants?**

Timings should be consistent with those provided in ongoing fire-drills.

**13. If a clearing member contributes a “significant” part of the default fund, should that clearing member automatically be included in the auction process? What reasons are there for not including the clearing member?**

Members risking juniorization should always be invited to the auction.

**14. The discussion paper discusses the trade-off between flexibility and predictability. How do you assess these trade-offs? Can you elaborate on the ways you provide for predictability while still maintaining flexibility (eg establishing rules and conditions to govern the determination of auction parameters)?**

Whilst flexibility is key, predictability is even more important for participating members, i.e. the CCP should not change the format of the auction or participation criteria during the last minute.

**15. If a CCP uses juniorisation as an incentive to encourage competitive bidding, and in a scenario where the CCP has invited only a subset of participants to an auction, how will the CCP apply the juniorisation to the clearing participants who were not invited?**

- Active market participants in a market related to a portfolio being auctioned off can be required to bid or risk being juniorised; such members should always be invited to the auction.
- Juniorisation measures may compromise the transparency of the loss waterfall structure in the default fund and should only be introduced with maximum transparency for members.
- Clearing members having an insignificant number of trades or small default fund contribution should not risk juniorisation.

## **Operational considerations (Chapter 5)**

**16. CCPs may distribute information that would help auction participants estimate the potential impact of a successful auction bid on their margin requirements. Besides those that members and clients would have during BAU, what information (and at what level of detail) or tools would be most useful for calculating these estimations and why?**

CCPs should provide tools that enable ad hoc calculations of margin impact; this would not only be useful in a default event.

In addition, CCPs should provide an estimate of the impact of an unsuccessful auction, e.g. what would the mutualized loss be if the auction was cancelled completely. This information could encourage improved bidding from auction participants.

**17. The sharing of confidential information (ie the defaulted participant's portfolio) carries potential risks, as discussed in the paper. What are the potential risks associated with information leakages, how does the CCP balance such risks with other objectives (eg sharing sufficient information for a successful auction), and what are the measures the CCP uses to address such risks?**

As highlighted in the general remarks, CCPs should have in place governance arrangements for confidential information needed to be shared with a limited group of market participants, i.e. when requesting quotes.

- These arrangements should include principles of transparency for selection criteria when certain stakeholders are invited to participate in transactions or are given information, and others are not.

In a default event, obtaining information early will enable front running of the market. To ensure all CCP members are aware and on an equal footing, all member should be informed that a default has happened, when the hedging phase is to be initiated and when the hedging phase has been finalized. This will ensure no members are caught by surprise and overrun by other members.

**18. CCPs use various modes of information transmission during a default management auction (eg email, web-based portal). Can you elaborate on which modes are the most effective in which circumstances and whether it varies depending on the type of information, and why? Would you consider web-based portals a best practice? If so, why?**

The fewer system dependencies, the better.

**19. What are the challenges and trade-offs of creating a realistic default management testing exercise? What processes are used to create the scenarios used in such exercises?**

- The credibility of the information gained from a test exercise vs in an actual default scenario can be a challenge, i.e. will auction participants provide the same quality of bids in a test exercise as in a default scenario?
- The fact that test exercises involve no consequences may result in auction participants submitting high quality bids during the test exercises, but not during an actual auction. This conundrum potentially diminishes or might even confuse the information value from the test exercise for the CCP.
- A member defaulting at multiple CCPs simultaneously needs to be aligned in the test exercises. This would prove challenging for the members at multiple clearing houses, but is likely to be a realistic scenario, given a member default.

**20. There may be benefits in pursuing greater standardisation and harmonisation across CCPs in relation to certain operational elements which support execution of an auction.**

**a. For example, should auction portfolio files be in a standard (or partially standardised) format (for different product types)? If so, which aspects of the portfolio file would benefit the most from cross-CCP standardisation (eg file type, layout, order of information or content)?**

Yes, standardisation across CCPs is preferable. The format should follow the standard fmpl format.

**b. Besides CCP portfolio files, which other operational elements would benefit (the most) from greater standardisation and harmonisation across CCPs?**

Alignment of requirements to pass the valuation phase of fire drills, where CCPs ensure all members are importing trades correctly. Particularly, valuation of trades based on CCP methodology and data

should be aligned between members and the CCP on a trade-by-trade basis to ensure large differences are not netted out on a portfolio basis.

c. Are there specific operational elements or areas where standardisation and harmonisation may not be helpful?

## Client participation (Chapter 6)

21. For which markets, asset or product classes and client types would client participation be most feasible and/or desirable? What would be the incentives for clients to participate in auctions? Does this differ for direct vs indirect client participation? Please elaborate in your response.

22. The discussion paper describes some ways to address the risks borne by a clearing member arising from its clients bidding in an auction. Are there additional ways to address the risks? Are there incentives that a CCP could employ to encourage client participation in an auction (eg ways to encourage clearing members to facilitate their clients' participation)?

a. One option for addressing a disparity in incentives between clearing members and clients is to require clients to contribute an established amount to the default fund prior to participating in an auction. What are the implications of this requirement (such as regulatory, economic or contractual implications) and how can a CCP address these implications?

## Default of a common participant across multiple CCPs (Chapter 7)

23. The discussion paper suggests that the conduct of multi-CCP default management exercises may provide useful insights into the hedging and auction procedures, should these be conducted by multiple CCPs concurrently. Can you elaborate on what specific insights could be obtained in relation to hedging and auctions via these multi-CCP default management exercises, if possible with concrete examples?

Yes, exercises should be done concurrently. This would:

- allow for execution of cross-CCP hedging trades and test potential. In addition, the enlarged liquidity pools would limit market impact and help to reduce risk in both auctions.
- help address uncertainties for the participating members on operational aspects.
- contribute to alignment between CCPs and limit the operational impact on members.

24. Feedback from the industry suggests that introducing a cap on the number of traders that can be seconded to multiple CCPs from a particular common clearing participant at any one time may mitigate the potential burden on clearing participants' participation in DMGs. How could such caps be instituted and implemented in practice? What could be the challenges of introducing such caps? Apart from caps, are there other options a CCP could consider to mitigate this potential burden?

We agree that introducing a cap on the number of traders that can be seconded to CCPs from a clearing member may mitigate the burden on the member's participation in DMGs.

25. Are there efficiencies or benefits to be gained from CCPs coordinating their respective default management auctions? If so, how?

a. Are there any arrangements that could be coordinated ex ante (eg cross-CCP netting arrangements)? How could these arrangements be established? What would be the challenges with these arrangements? How could these challenges be mitigated?

Coordination of auction timings would be preferable as running the auctions simultaneously could prove challenging for members with limited staff. For instance, it could prove challenging for a single trader to access systems, price portfolios and submit the bids at two CCP auctions simultaneously.

In a situation where a counterparty defaults on two or more CCPs, the CCPs should first seek to reduce the aggregate risk in the portfolio exposure by closing out offsetting trades directly prior to commencing any hedging and the auction process.

## General

**26. Are there any additional points of consideration that would contribute to a successful auction that are not mentioned in this discussion paper? If so, what are they?**

The discussion paper does not discuss the behavioral aspects between an actual default management auction and a test exercise. The SSDA encourages further discussions and knowledge sharing to shed light on auction participant bidding behavior.

**27. What are the potential areas in the context of default management auctions where additional guidance might be most welcome?**

Increased transparency and guidance of the consequences for not submitting bids or submitting very conservative bids during fire-drills would be very welcome.

**Any other comments/feedback on areas not mentioned above:**

- Everything the CCP intends to do in the event of a default (e.g. auction format, method of communication, data delivery etc.) should be reflected in the CCP's ongoing fire-drills. This would mean, that a CCP in general should not be able to introduce new processes or principles without having run a fire-drill to test the introduction of those processes and principles first. It would also support the predictability for auction participants and the operational functioning of the auction.
- Standardisation of the framework for disclosures requirements of CCPs' auction processes and alignment of the auction formats within assets classes across CCPs is desirable in terms of promoting access for smaller bidders and transparency.
- Generally, regulators role in overseeing and prompting necessary transparency in CCPs' default management practices should be clearer.
  - Specifically, regulators should be mandated to increase the junior capitalization (the CCP's contribution to the loss waterfall default fund structure) in the event the CCP's default management procedure is deemed insufficient. This would
    - i. create the correct incentives for CCPs,
    - ii. help protect members in the event of an ill-run default management process, and
    - iii. thereby help prevent financial contagion in the event of a member default.

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